



THE TAX GAP'S MANY SHADES OF GRAY

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The “tax gap”—the difference between the amount of taxes owed and the amount of tax actually paid—includes substantial gray areas where the law is ambiguous and the IRS’s determination of taxes owed is debatable. Understanding the tax gap’s shades of gray can inform discussions of tax law and policy. Our analysis highlights the importance of both reforming substantive tax law and increasing IRS enforcement as complementary strategies to improve tax compliance.

The “tax gap”—the difference between taxes owed to the government and taxes actually collected—has gained new attention in recent months. In May 2021, the Treasury Department projected that the gross tax gap—the difference between taxes owed and taxes voluntarily and timely paid—totaled \$630 billion in tax year 2019 (after “adjusting the tax gap for passthrough and offshore evasion”).¹ The net tax gap—which accounts for enforced and other late payments—was still a staggering \$554 billion in tax year 2019, according to Treasury’s adjusted projection.²

Notwithstanding its prominence, the tax gap is also a subject of considerable confusion. Much commentary on the subject equates the tax gap with “tax evasion,” a term broadly understood to connote intentional (and potentially criminal) underreporting. However, the tax gap as defined by the Internal Revenue Service (IRS) includes all taxes that are underreported, whether willfully or not. The IRS’s estimate of the tax gap also includes instances in which taxpayers try to exploit ambiguities—gray areas—in the tax code but are ultimately found by the courts to be on the wrong side even if their close-to-the-line conduct falls far short of criminality. It includes instances in which taxpayers make honest mistakes while trying to comply with ever-changing and often-opaque tax laws. On top of that, the tax gap includes the liabilities of well-intentioned taxpayers who acknowledge what they owe but are unable to pay because of financial

¹ US Department of the Treasury, “The American Families Plan Tax Compliance Agenda” (May 2021), 4–5 and table 1.

² US Department of the Treasury, “American Families,” 4.

distress. For all these reasons, official IRS documents are generally careful not to characterize the tax gap as tax evasion.³

Moreover, several features of the IRS's methodology create the possibility that the agency's estimate will include amounts that a court—or even the IRS itself—won't ultimately deem the taxpayer to owe. The IRS's measure of "true tax"—the starting point for its calculation of both the gross and net tax gaps—includes any amount of additional tax recommended by an examiner after an audit included in its compliance studies, even if the examiner's post-audit recommendation is subsequently reversed on administrative appeal or court challenge. Data from the Treasury Inspector General for Tax Administration indicate that only 63 percent of additional taxes recommended by examiners in operational audits in fiscal years 2015 through 2019 were ultimately assessed (after administrative appeals and abatements).⁴ That figure is likely even lower after taking into account further reductions on judicial review.

In addition, the IRS uses a method called "detection controlled estimation" in its compliance studies to scale up the recommendations of all examiners to the level of the examiners who recommend the largest upward adjustments in types of personal income, controlling for observable characteristics of the cases assigned to each examiner. The intent of detection controlled estimation is to account for income that was not detected in an audit, but flaws in that method potentially magnify the impact of later-reversed recommendations on the overall tax gap.

Weighing in the opposite direction, other features of the IRS's methodology cause the agency's estimate of the tax gap to exclude amounts that are tax evasion by any definition. Of particular note, the IRS's tax gap estimates do not include underreporting attributable to illegal-source income. The IRS says that it omits noncompliance attributable to illegal-source income⁵ from its tax gap estimates because (1) illegal-source income is "extremely difficult to estimate" and (2) "the government interest in pursuing this type of noncompliance is, ultimately, to stop the illegal activity, not merely to tax it."⁶

The IRS's official tax gap estimates also may exclude underreporting attributable to passthrough entities such as partnerships and S corporations because audits of those organizations are not routinely conducted as part of IRS compliance studies.

Between clear-cut noncompliance and compliance, however, lies a spectrum of many shades of gray, where taxpayers, the IRS, the courts, and Congress may disagree as to what counts as illegal or legal. (Indeed, even within the IRS, there are often various views among examiners and differences of opinion between examiners and appeals officers.) Understanding the tax gap's shades of gray can inform discussions of tax law and policy. Clarifying the contours of the tax gap also yields three concrete policy implications:

1. THE TAX GAP SHOULD NOT BE A PERFORMANCE TARGET.

The IRS's tax gap research reveals important sources of noncompliance and sheds light on the potential amounts of unpaid taxes that could be collected under current law. But a goal such as reducing the tax gap by a particular percentage aims at an amorphous target. Moreover, setting such a goal for the IRS would produce potentially perverse incentives. For example, one easy way for the IRS to reduce the measured tax gap would be to instruct examiners not to

³ See, e.g., Internal Revenue Service, Publication 1415 (Rev. 9-2019) (2019) (the term "evasion" is not used in body text).

⁴ Treasury Inspector General for Tax Administration, "Trends in Compliance Activities through Fiscal Year 2019," March 12, 2021, 16, figure 6.

⁵ IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, August 2007, 6 ("It is important to emphasize that IRS estimates of the tax gap are associated with the legal sector of the economy only"); Kim M. Bloomquist, "IRS Compliance Research and Tax Gap Estimates," slide deck presented at the 2007 FTA Revenue Estimation and Tax Research Conference, September 17, 2007 (noting that illegal source income is "not included in tax gap estimates").

⁶ IRS, *Reducing the Federal Tax Gap*, 6.

challenge aggressive reporting positions adopted by sophisticated taxpayers who exploit gray areas in the tax code. The IRS would thereby reduce the amount of true tax owed—and thus the gap between true tax and the amount actually paid. However, such measures would be at odds with the goals of raising revenue and allocating tax burdens equitably.

2. THE IRS NEEDS SKILLED AND EXPERIENCED EXAMINERS AND UP-TO-DATE TECHNOLOGY TO BETTER ADDRESS THE PROBLEM OF TAX NONCOMPLIANCE.

If distinguishing between tax compliance and noncompliance were simple, then the IRS potentially could rely on relatively inexperienced examiners to detect tax underreporting. However, to the extent the tax gap results from sophisticated taxpayers aggressively exploiting ambiguities in the statutes, then the IRS's task is more challenging. In certain areas, such as the taxation of passthrough entities, noncompliance often takes the latter form. For example, rules regarding special allocations for partnerships and reasonable compensation for S corporation shareholders involve complicated multipart tests that are often unclear in their application. In those circumstances, enforcement would be especially resource intensive and would require a substantial boost in the IRS's budget. The IRS will need to hire, train, and retain revenue agents who are well versed in the relevant areas of law and capable of conducting complex audits, then support their efforts with 21st-century technology. These enforcement efforts may take a long time to pay off, especially when the taxpayer appeals the examiner's decision through the administrative process or takes the matter to the courts.

3. TACKLING THE PROBLEM OF TAX NONCOMPLIANCE REQUIRES SUBSTANTIVE LEGAL REFORMS.

Even the most skilled and experienced examiners will struggle to enforce tax laws that are ambiguous at their core. In those cases, audits are no substitute for clarity in the tax laws. This point is most evident with passthrough entities (e.g., partnerships and S corporations), for which current statutes practically invite taxpayers to adopt aggressive reporting positions—some challenged by examiners, some accepted as legal avoidance strategies, and some that are never observed because audits at the passthrough-entity level are rare. Congress could write better tax rules for passthrough entities that would make the IRS's task much easier and would make enforcement more equitable. Some examples of tax laws that would achieve those goals include the following:

- Repeal the deduction for qualified business income under section 199A.
- Abolish partnership special allocations and require partnerships to allocate tax items in proportion to capital interests.
- Apply the self-employment tax to the distributive-share income of active S corporation shareholders.

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